

# Monetary Policy

Monetary policy refers to the credit control measures adopted by the central bank of a country. In case of Indian economy, RBI is the sole monetary authority which decides the supply of money in the economy.

**The instruments of monetary policy are of two types:**

**1. Quantitative**, general or indirect (CRR, SLR, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate)

**2. Qualitative**, selective or direct (change in the margin money, direct action, moral suasion)

These both methods affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements (cash reserve ratio, statutory reserve ratio).

Policy instruments are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

**We discuss them as under:**

**a. Bank Rate Policy:**

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflation has been increasing continuously, it raises the bank rate so borrowing from the central bank becomes costly and commercial banks borrow less money from it (RBI).

The commercial banks, in reaction, raise their lending rates to the business community and borrowers who further borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate.

It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to

borrow more. Investment is encouraged and followed by rise in Output, employment, income and demand and the downward movement of prices is checked.

**b. Open Market Operations:**

Open market operations refer to sale and purchase of securities in the money market by the central bank of the country. When prices start rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community or general public.

Further investment is discouraged and the rise in prices is checked.

Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised so they lend more to business community and general public. It further raises Investment, output, employment, income and demand in the economy hence the fall in price is checked.

**c. Changes in Reserve Ratios:**

Under this method, CRR and SLR are two main deposit ratios, which reduce or increases the idle cash balance of the commercial banks. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

**Cash Reserve Ratio (CRR)**

It refers to the cash which banks have to maintain with the Reserve Bank of India as percentage of Net Demand and Time Liabilities (NDTL). An increase in CRR makes it mandatory for banks to hold large portion of their deposits with the RBI. Therefore, it reduces their deposit available for credit and they lend less which affect their profitability and also reduces the money supply in economy.

**Statutory Liquidity Ratio (SLR)**

Apart from CRR, the banks in India are required to maintain liquid assets in the form of gold, cash and approved securities. The increase/decrease in SLR affects the availability of money for credit with banks.

### Liquidity Adjustment Facility (LAF)

Under Liquidity Adjustment Facility (LAF) the banks purchase money from RBI on repurchase agreements.

- **Repo Rate:** It is the interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF)
- **Reverse Repo Rate:** The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF

### Marginal Standing Facility

Under SF, the scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system

## 2. Selective Credit Controls:

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them.

### a. Change in Margin Money:

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 70% means that the pledger of securities of the value of Rs 10,000 will be given 30% of their value, i.e., Rs 3,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

**b. Moral Suasion:** Under this method RBI urges to commercial banks to help in controlling the supply of money in the economy.

### **Monetary Policy Committee**

The Monetary Policy Committee has been constituted by central government in September 2016 for maintaining price stability, while keeping in mind the objective of growth.

The committee consists of six members of which three Members are from the RBI and the other three Members of MPC are appointed by the Central Government:

- The Governor of the Bank—Chairperson, ex officio
- Deputy Governor of the Bank, in charge of Monetary Policy—Member, ex officio;
- One officer of the Bank to be nominated by the Central Board—Member, ex officio;
- Three members to be nominated by Central government

The Members of the Monetary Policy Committee appointed by the Central Government shall hold office for a period of four years.

### **Objectives and scope of the Monetary Policy**

**1. Price Stability:** Price Stability implies promoting economic development with considerable emphasis on price stability. Monetary policy is, therefore an important tool to control trade cycles. The centre of focus is to facilitate the environment which is favourable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

**2. Controlled Expansion of Bank Credit:** One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

### **3. Neutrality of Money:**

Economists like Hayek and Robertson are the chief exponents of neutral money. They hold the view that monetary authority should aim at neutrality of money in the economy. Any monetary change is the root cause of all economic fluctuations. According to neutralists, the monetary change causes distortion

and disturbances in the proper operation of the economic system of the country.

#### **4. Exchange Stability:**

Exchange stability was the traditional objective of monetary authority. This was the main objective under Gold Standard among different countries. When there was disequilibrium in the balance of payments of the country, it was automatically corrected by movements. This system will correct the disequilibrium in the balance of payments and exchange stability will be maintained.

#### **5. Full Employment:**

During world depression, the problem of unemployment had increased rapidly. It was regarded as socially dangerous, economically wasteful and morally deplorable. Thus, full employment assumed as the main goal of monetary policy. In recent times, it is argued that the achievement of full employment automatically includes prices and exchange stability.

#### **6. Economic Growth:**

In recent years, economic growth is the basic issue to be discussed among economists and statesmen throughout the world. Economic growth is defined as the process whereby the real per capita income of a country increases over a long period of time. It implies an increase in the total physical or real output, production of goods for the satisfaction of human wants.

#### **The monetary policy has the limited scope in the underdeveloped countries because of the following reasons:**

(i) There exists a large non-monetised sector in most of the underdeveloped countries which act as a great hurdle in the successful working of the monetary policy.

(ii) Small-sized and unorganised money market and limited array of financial assets in underdeveloped countries also hinder the effectiveness of monetary policy.

(iii) In most of the underdeveloped countries, total money supply mainly consists of currency in circulation and bank money forms a very small portion

of it. This limits the operation of central bank's monetary policy which basically works through its impact on bank money.

(iv) The growth of nonbank financial institutions also restricts the effective implementation of monetary policy because these institutions fall outside the direct control of the central bank.

### **Limitations of Monetary Policy:**

The following are the main limitations of the monetary policy:

- **Effects Have a Time Lag**  
Even if implemented quickly, the macro effects of monetary policy generally occur after some time has passed. The effects on an economy may take months or even years to materialize. Some economists believe money is "merely a veil," and while serving to stimulate an economy in the short-run, it has no long-term effects except for raising the general level of prices without boosting real economic output.
- **Technical Limitations**  
Interest rates can only be lowered nominally to 0%, which limits the bank's use of this policy tool when interest rates are already low. Keeping rates very low for prolonged periods of time can lead to a liquidity trap. This tends to make monetary policy tools more effective during economic expansions than recessions.
- **Monetary Tools Are General and Affect an Entire Country**  
Monetary policy tools such as interest rate levels have an economy-wide impact and do not account for the fact some areas in the country might not need the stimulus, while states with high unemployment might need the stimulus more. It is also general in the sense that monetary tools can't be directed to solve a specific problem or boost a specific industry or region.
- **The Risk of Hyperinflation**  
When interest rates are set too low, over-borrowing at artificially cheap rates can occur. This can then cause a speculative bubble, whereby prices increase too quickly and to absurdly high levels. Adding more money to the economy can also run the risk of causing out-of-control

inflation due to the premise of supply and demand: if more money is available in circulation, the value of each unit of money will decrease given an unchanged level of demand, making things priced in that money nominally more expensive.